U.S. CHAMBER OF COMMERCE

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December 9, 2013

Prof. Dr. Dirk Andreas Zetzsche, LL.M.
Chairman
Best Practice Principles for Governance
Research Providers Group
via email: consultation@bppgrp.info

Re: Best Practice Principles for Governance Research Providers Group

Dear Dr. Zetzsche:

The U.S. Chamber of Commerce ("the Chamber"), the world's largest business federation, represents the interests of more than three million businesses and organizations of every size, sector, and region. The Chamber has recently established the Global Risk and Governance Initiative ("GRGI") to promote modern and appropriate international structures for capital formation, risk management, and corporate governance needed by businesses to fully function in a 21st century economy. Members of the Chamber operate in all nations of the European Union and we welcome the European Securities and Markets Authority's ("ESMA") foresight in undertaking this effort to develop the *Best Practice Principles for Governance Research Providers Group*. Issues on proxy advice are global in nature and should be considered in the appropriate international regulatory context.

The Chamber has long sought to engage in a constructive, substantive dialogue with proxy advisory firms, public companies, and other stakeholders in the proxy voting process to advance reasonable reforms for the benefit of shareholders.[1] In March of this year, the Chamber published its *Best Practices and Core Principles for the*

[1]For example, to follow-up on an active dialogue that the Chamber had fostered with corporate secretaries and ISS to correct some of these flaws, the Chamber in 2010 wrote to ISS and the SEC with a proposal to introduce transparency and accountability by creating specific processes for voting policies and recommendations. *See* Memorandum from U.S. Chamber of Commerce to ISS (Aug. 4, 2010), available at http://www.sec.gov/comments/s7-14-10/s71410-268.pdf. This would have allowed for an open dialogue in which all stakeholders could have participated, and would have better informed ISS of circumstances material to the interests of its clients. To date ISS has not acted or commented on these recommendations. The Chamber, to date, has not had substantive discussions with Glass Lewis.

Development, Dispensation, and Receipt of Proxy Advice ("Chamber Core Principles and Best Practices").[2] The ultimate goal of this effort is to provide a starting point for the collaborative development, by all stakeholders in the proxy voting process, of a universally embraced private-sector system that brings transparency and accountability to the activities of proxy advisory firms, fosters strong corporate governance, and ensures that the economic best interests of public company shareholders is the exclusive focus of all operative participants in the proxy voting process. Importantly, the Chamber Core Principles and Best Practices contain recommendations directed not only to proxy advisory firms' conduct, but also to the conduct of public companies and investment advisers.

The GRGI appreciates this opportunity to offer its comments on the Best Practice Principles for Governance Research Providers ("Principles") published on 28 October 2013, by the industry group ("Industry Group") you Chair.[3] While the Principles apparently are intended to have immediate applicability in Europe, at least one member of the Industry Group has indicated that the intent is that the Principles apply globally.[4] Therefore, we offer the following comments on the U.S. experience with the two largest U.S.-based proxy advisory firms, Institutional Shareholder Services ("ISS") and Glass, Lewis & Co. ("Glass Lewis"), which together account for 97% of the market for proxy advisory services in the United States.[5]

ESMA stated, in its Final Report Regarding the Role of the Proxy Advisory Industry ("ESMA Final Report"), that, while it has "not been *provided* with clear evidence of market failure" attributable to proxy advisory firms, it nevertheless believed "that there are several areas, in particular relating to transparency and disclosure," where further efforts are necessary to ensure efficient markets and foster

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[2]US Chamber of Commerce Center for Capital Markets Competitiveness, Best Practices and Core Principles for the Development, Dispensation, and Receipt of Proxy Advice (Mar. 2013), available at http://www.centerforcapitalmarkets.com/wp-content/uploads/2010/04/Best-Practices-and-Core-Principles-for-Proxy-Advisors.pdf. A copy of the Chamber Core Principles and Best Practices is annexed for your convenience.

[3]The Principles are available at http://bppgrp.info/wp-content/uploads/2013/11/BPP-Group-Principles-Consultation.pdf .

[4]K. Rabin, Chief Executive Officer of Glass, Lewis & Co., Comments at U.S. Securities and Exchange Commission ("SEC") Proxy Advisory Firm Roundtable (Dec. 5, 2013) ("SEC Proxy Advisory Firm Roundtable"), available at http://www.sec.gov/news/otherwebcasts/2013/proxy-advisory-services-roundtable-120513.shtml (relevant portion begins at 3:52:40).

[5]*See* J. Glassman & J. Verret, HOW TO FIX OUR BROKEN PROXY ADVISORY SYSTEM, 8, Mercatus Center, George Mason Univ. (Apr. 16, 2013), available at http://mercatus.org/sites/default/files/Glassman_ProxyAdvisorySystem_04152013.pdf ("Mercatus Paper").

effective stewardship and robust corporate governance.[6] In fact, however, there does exist evidence of a market failure—or "compelling impetus"—for proxy advisory firms to be subject to far higher standards than they have adopted to this point on their own initiative.[7] Much like the history of credit rating agencies in the U.S., the two market-dominant proxy advisory firms are an effective duopoly as a result of SEC regulation.

As a result of effective barriers to competition stemming from SEC regulations and interpretations, these proxy advisory firms' processes and procedures for researching, formulating and applying their voting recommendations are not transparent, and both firms' services are rendered despite the fact that they are plagued by overwhelming conflicts of interest,[8] many of which are not adequately disclosed to their clients, or the shareholders on behalf of whom their clients retain them. The impact of similar types of entry barriers to credit rating agencies ultimately played a major role in the events leading to the 2007-2008 financial crisis.[9] The GRGI believes that ESMA, and the Industry Group you chair, should be concerned that a confluence of the same factors that were applicable to credit rating agencies may also be applicable to proxy advisory firms, with comparably untoward results.[10]

The GRGI agrees with ESMA's conclusion that formal rulemaking is not necessary at this time. But, given ESMA's recognition that proxy advisors are only

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[6] ESMA Final Report, at p. 3 (Feb. 19, 2013) (emphasis supplied), available at http://www.esma.europa.eu/system/files/2013-84.pdf ("ESMA Final Report").

[7] *See* Mercatus Paper, *supra* n. 5 at pp. 20-21. *See* also Hon. M. Piwowar, Commissioner, SEC, Opening Statement at the SEC Proxy Advisory Firm Roundtable (Dec. 5, 2013), available at http://www.sec.gov/News/Speech/Detail/Speech/1370540449928#.UqHuEdJDuGc. (noting "many similarities between the current situation with proxy advisory firms and the pre-crisis situation with credit rating agencies, including an unhealthy over-reliance on their recommendations by investors").

[8] *See*, *e.g.*, Mercatus Paper, *supra* n. 5 at pp. 20-21.

[9] *Id.*

[10] The influence of proxy advisory firms has been cited as a contributing factor to firms' decisions to forego initial public offerings in the U.S.. *See* E. Knight, General Counsel, NASDAQ OMX, Keynote Address at the U.S. Chamber of Commerce Center for Capital Markets Competitiveness: Preserving a Heritage of Opportunity for Entrepreneurs and Investors (Dec. 5, 2012), available at http://www.uschamber.com/webcasts/examining-role-proxy-advisory-firms (remarks begin at 1:38:51). Additionally, there is evidence in the academic research that proxy advisors' favored policies on compensation may in fact have a negative impact on share value. *See* D. Larker, A. McCall and G. Ormazabal, THE ECONOMIC CONSEQUENCES OF PROXY ADVISOR SAY-ON-PAY VOTING POLICIES, Stanford Graduate School of Business Research Paper No. 2105 (July 5, 2012), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2101453. Since proxy advisory firms are ubiquitous, the consequences of their current lack of standards are likely to be felt globally, not merely in the U.S.

one part of a chain of interlinked responsibilities to shareholders,[11] we are concerned that the effort to create Principles is apparently taking place only through an Industry Group that does not include representatives of the many other constituencies—such as portfolio managers, institutional investors, public companies and others—that have a deep stake in the ultimate formulation of Principles.

Past experience offers little reason to believe that proxy advisory firms are willing to undertake necessary reforms on their own initiative.[12] As ESMA is undoubtedly aware, in 2011, France's Autorité Des Marchés Financiers issued Recommendation 2011-06 ("AMF Recommendation"), calling on proxy advisors to take a number of important steps to introduce greater transparency, accountability, and responsiveness to proxy advisors' performance of services in four areas:

- establishing and issuing the voting policy;
- establishing and submitting voting recommendations to investors;
- communicating with listed companies, and ;
- preventing conflicts of interest.[13]

In response, ISS and Glass Lewis each claimed—erroneously—that they had implemented the AMF Recommendation regarding communications with issuers. But, these two firms merely undertook to provide issuers with copies of their reports *following* their publication of those reports to clients, and touted this in public press

[11] ESMA Final Report, *supra* n. 6, at p. 8 ¶26.

[12] Indeed, at the SEC Proxy Advisory Roundtable, Glass-Lewis' CEO, Ms. Rabin, suggested that there was no need for the SEC even to concern itself with the serious issues surrounding the performance of services by proxy advisory firms merely because Glass Lewis had already subscribed to the Principles. *See* n. 4, *supra*.

[13] Autorité Des Marchés Financiers, AMF RECOMMENDATION 2011-06, PROXY VOTING ADVISORY FIRMS (Mar. 18, 2011), available at http://www.amf-france.org/en_US/Reglementation/Doctrine/Doctrine-list/Doctrine.html?category=I+-+Issuers+and+financial+disclosure&isSearch=true&xtmc=2011-06&lastSearchPage=http%3A%2F%2Fwww.amf-france.org%2FmagnoliaPublic%2Famf%2FResultat-de-recherche.html%3FLANGUAGE%3Dfr%26valid_recherche%3DValider%26isSearch%3Dtrue%26TEXT%3D2011-06%26simpleSearch%3Dtrue&docVersion=1.0&docId=workspace%3A%2F%2FSpacesStore%2F12e1aead-0ff9-4f26-8fd0-d0ebe29d0efe&xtcr=1&docVersion=1.2&langSwitch=true.

releases, even though the AMF Recommendation contemplated *pre-publication* review and proxy advisory firm responsiveness to *comments* by issuers.[14]

The GRGI's concern, therefore, is that despite ESMA's efforts to foster transparency and accountability through the Industry Group, effective and long-lasting reform may not be achievable without the participation of all constituencies with an interest in the proxy voting process. The Chamber Core Principles and Best Practices represent one viewpoint in a discussion that needs to include a broader scope of participation, but we believe it would enhance ESMA's efforts, as well as those in the U.S., if we had the opportunity to meet and engage in an in-depth discussion about the Chamber Core Principles and Best Practices and, specifically, the need for a broader participation of constituencies than presently embodied by the Industry Group.

The GRGI believes it is critical that any long-lasting, private sector-directed corporate governance reforms must include the active participation of all stakeholders. Accordingly, we stand ready to assist ESMA in bringing about a transparent and accountable corporate governance system that encourages shareholder communication and participation.

We would be happy to discuss our comments in further detail with you or the appropriate staff.

Sincerely,

Gary Litman

Tom Quaadman

[14] *Id.* Moreover, Glass Lewis only agreed to make its reports available *for sale* following publication to clients. *See* Glass, Lewis & Co., AMF Recommendation for Proxy Advisors, available at http://www.glasslewis.com/issuer/amf/. *See also,* Institutional Shareholder Services, ISS Updates Compliance with AMF Recommendation No. 2011-06 of March 18 2011 on Proxy Advisory Firms (Mar. 2012), available at http://www.issgovernance.com/policy/FrenchDraftReviewAnnouncement.